

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Committee On Budget Analyst: Gail Hall Bill Number: AB 198
Related Bills: See Legislative History Telephone: 845-6111 Amended Date: September 11, 2007
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Limited Liability Company Fee/Remedy For Final Court Decisions

SUMMARY

This bill would do the following:

- Apply certain rules for assigning the income of entities doing business within and outside the state to the calculation of the Limited Liability Company (LLC) fee, and
- Provide a statutory remedy for the LLC fee statute if it is found unconstitutionally discriminatory or unfair.

SUMMARY OF AMENDMENTS

The September 11, 2007, amendments removed the legislative intent language to enact statutory changes relating to the budget and added amendments relating to the LLC fee.

This is the department's first analysis of AB 198.

PURPOSE OF THE BILL

It appears the purpose of this bill is to remove any uncertainty surrounding undefined terms used in the statute and to make a fair and equitable application of the fee to all LLCs doing business within and outside of the state.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. The new rule for determining total income derived from or attributable to California would specifically be operative for taxable years beginning on or after January 1, 2007, and contains a "no inference" clause with respect to taxable years beginning before January 1, 2007.

The statutory remedy would specifically apply to lawsuits filed before, if not final, the date of enactment, and to lawsuits filed on or after the date of enactment.

POSITION

Pending.

¹ Revenue and Taxation Code section 17942.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Selvi Stanislaus

9/24/07

ANALYSIS

FEDERAL/STATE LAW

Federal law lacks provisions that require any LLC to pay an annual tax or fee.

Under current state law, an LLC not classified as a corporation must pay the \$800 annual LLC tax and the annual LLC fee if it is organized, doing business, or registered in California. The annual LLC fee is based on the LLC's total income from all sources reportable to the state. Total income is defined as gross income from whatever source derived¹ plus the cost of goods sold that are paid or incurred in connection with a trade or business. Current law lacks a definition for "from all sources reportable to the state;" however, the department has interpreted this term to mean worldwide total income without apportionment. Total income excludes the flow-through of total income from one LLC to another LLC if that income has already been used to determine the annual LLC fee of an LLC. The following chart is used to determine the amount of the fee:

[---If Total Income From All Sources Reportable To This State Is---]

Equal To Or Over (\$)	But Not Over (\$)	LLC Fee (\$)
250,000	499,999	900
500,000	999,999	2,500
1,000,000	4,999,999	6,000
5,000,000	And over	11,790

California has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), with certain modifications, to determine how much of a taxpayer's net income, which is earned from activities both inside and outside of California, is attributable to California and subject to California franchise or income tax. An apportionment formula is used to determine the amount of "business"² income attributable to California. The apportionment formula consists of property, payroll, and sales factors.

The sales factor is determined by dividing total sales in California by total sales worldwide during the taxable year.

The following is a list of the general rules utilized to determine California sales for the sales factor calculation:

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser out of state, and the taxpayer (seller) is not taxable in the state of destination.

¹ Revenue & Taxation Code (R&TC) Section 24271 and Internal Revenue Code (IRC) Section 61.

² R&TC Section 25120(a) defines business income as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

- Sales of tangible personal property to the U.S. Government are assigned to California if the goods were shipped from California.
- Sales from the performance of personal services are assigned to California if the services were performed in California. If personal services were performed in more than one state, then the receipts from the services would be assigned to California based on the ratio of time spent performing such services in the state to total time spent in performing such services everywhere.
- Sales from intangibles and all other services are assigned to California if the income producing activity that gave rise to the receipts is performed wholly within California. If the income producing activity is performed within and outside the state, then the sales from intangibles and all other services are assigned to California if the greater cost of performance of the income producing activity is performed in this state.
- Sales from the sale, rental, lease, or licensing of real property and the receipts derived from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

There are additional rules for assigning sales to California for sales factor purposes, including special rules established in regulations issued under California Revenue and Taxation Code (R&TC) section 25137³ for cases where the general rules for assigning sales to California would unfairly represent the taxpayer's business activities within the state.

THIS BILL

This bill would amend current law to do the following:

- Determine an LLC's fee based on the LLC's total income from all sources derived from or attributable to the state. The level of activity would be determined by applying the current law's franchise/income tax sales factor rules to the total income of the LLC (as defined in the bill) in order to calculate the amount of total income from all sources derived from or attributable to the state.
- Provide that, after the LLC fee is finally adjudged to be discriminatory or unfairly apportioned, any taxpayers that file claims for refund asserting that the LLC fee is discriminatory or unfairly apportioned in violation of the California Constitution or the laws or Constitution of the United States would have the amount of their claim for refund recalculated in an amount necessary to remedy the discrimination or unfair apportionment required by the statute
- Specify that refunds of fees payable as a result of pending litigation challenging the validity of the LLC fee would be limited to the amount of the LLC fee paid, plus any interest assessed, that exceeds the amount of LLC fee that would have been assessed if the fee had been computed using the rules added by this bill.

LEGISLATIVE HISTORY

³ California Code of Regulations (CCR), title 18, section 25137.

AB 1546 (Calderon, 2007/2008) had the same provision as this bill in that it would change the method used by LLC's to calculate total income from California sources, but this bill would have expanded the remedy to final court decisions that determine a tax, fee, deduction, credit, or exclusion was unconstitutional. AB 1546 was placed in the Assembly inactive file by request of the author.

SB 749 (Oropeza, 2007/2008) would have applied the apportionment and allocation rules to an LLC's total income before calculating the LLC fee. In addition, SB 749's operative date would have been for taxable years beginning on or after January 1, 2001. SB 749 was held in the Senate Revenue and Taxation Committee.

AB 1614 (Ruskin, 2005/2006) would have applied the apportionment and allocation rules for assigning the income of entities doing business within and outside the state to the calculation of the state's LLC fee to remove this constitutional issue. This bill would have been operative for taxable years beginning on or after January 1, 2001. Governor Schwarzenegger vetoed AB 1614 stating, "This bill would impact how fees are collected from businesses choosing to operate as limited liability companies. As litigation is currently pending regarding this matter, it is premature to take legislative action at this time. For this reason, I am returning the bill without my signature." (See Appendix A for the complete veto message.)

AB 898 (Stats. 2001, Ch. 391) set the LLC fee at a fixed amount and repealed the annual study and adjustment of the LLC fee.

SB 469 (Stats. 1994, Ch. 1200), known as the Beverly-Killea Limited Liability Act, authorized limited liability companies for the first time to organize and register in the state. To offset the estimated loss in tax revenue due to the increase in businesses organizing as LLCs instead of corporations, an annual LLC fee was required based on the total income from all sources reportable to the state.

PROGRAM BACKGROUND

In *Northwest Energetic Services, LLC v. Franchise Tax Board*, Case No. CGC-05-437721, the San Francisco Superior Court held in its Statement of Decision that the LLC fee could not be applied constitutionally to the Plaintiff because the LLC fee is an unapportioned tax and thus violates the Commerce Clause of the United States Constitution and the Due Process Clauses of the California and United States Constitutions. The Plaintiff is an LLC that registered with the California Secretary of State, and its income was derived solely from sources outside of California. FTB has appealed this decision in the California Court of Appeal. The department will continue to enforce current law unless a final appellate decision is rendered to the contrary.

In *Ventas Finance I, LLC v. Franchise Tax Board*, Case No. CGC-05-440001, the San Francisco Superior Court held in its Statement of Decision that the LLC fee imposed on the Plaintiff is an unapportioned tax that violates the Commerce Clause of the United States Constitution and the Due Process Clauses of the California and United States Constitutions. The Court also held that the statutory language of R&TC section 17942 could not be judicially reformed. The Plaintiff is an LLC that registered with the California Secretary of State, and its income was derived from sources within and outside California. FTB has appealed this decision in the California Court of Appeal. The department will continue to enforce current law unless a final appellate decision is rendered to the contrary.

Bakersfield Mall, LLC v. Franchise Tax Board, Case No. 462728, is currently before the San Francisco Superior Court. The Plaintiff is an LLC that registered with the California Secretary of State and alleges its income was derived solely within California. The Plaintiff claims that the LLC fee is an unapportioned tax that violates the Commerce Clause of the United States Constitution and the Due Process Clauses and the Equal Protection Clauses of the California and United States Constitutions.

This bill would prospectively resolve the constitutional issues raised in the pending litigation with regard to the LLC fee for taxable years beginning on or after January 1, 2007.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, Illinois, Massachusetts, and Michigan lack provisions requiring an LLC to pay an annual fee.

Minnesota requires a limited liability partnership and an LLC treated as a partnership to pay an annual entity level fee that ranges from \$0 to \$5,000. The fee is based on the sum of an entity's *Minnesota* property, payroll, and sales.

New York requires every domestic and foreign LLC that is treated as a partnership and has any income, gain, loss, or deduction from *New York* sources to pay an annual filing fee. The amount of the filing fee is \$50 multiplied by the total number of members in the LLC. The minimum fee a LLC must pay is \$325 and the maximum fee is \$10,000, annually. Members include resident and nonresident individuals, estates and trusts, corporations, or other LLCs or partnerships.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Based on data and assumptions discussed below, the revenue impact from this bill would be as follows:

Estimated Revenue Impact of AB 198 Enactment Assumed after June 30, 2007 Accrual Basis (\$ in Millions)			
2006/07	2007/08	2008/09	2009/10
\$0	- \$40	- \$45	- \$50

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This bill would codify the remedy if the LLC fee statute is held discriminatory or unfairly apportioned in violation of the California Constitution or the laws or Constitution of the United States as applied. This

remedy is consistent with the recent decision of the California Court of Appeal in *Macy's Department Stores, Inc. v. City and County of San Francisco*, which held that Due Process only required the city to refund the amount that was necessary to alleviate the amount of tax that was found to be improper in this case, and therefore, this bill has no revenue impact.

Under this bill, LLC fees would be determined based on assigned total income to California rather than worldwide total income. In 2004, there were \$246 million in LLC fees collected from 164,206 LLC returns. LLC fees are projected to grow to \$415 million in 2009.

This estimate is based on a representative sample of more than 1,800 LLC returns from 2004. A subset of more than 500 LLC returns reported sales factor information. For each LLC return in the subset, the LLC fee was first calculated using current law's worldwide total income. Second, the LLC fee was calculated using the proposed bill's assigned total income to California. The results were compared and based on the testing, it was determined that this bill would have decreased the amount of fees collected by just over 12%. The 12% was applied to the 2004 total LLC fees collected, and it was estimated that this bill would have decreased the amount of fees received in 2004 by 12%, or \$30 million (12% x \$246 million). The \$30 million was grown to subsequent years and converted to fiscal years.

Although the May 3, 2007, amendments replaced the method LLCs would use to determine total income assigned to California from utilizing an apportionment formula to utilizing current law's rules for computing the numerator of the sales factor, the revenue impact stayed the same. One reason the revenue impact stayed the same was due to rounding. The revenue estimate of the provisions of the bill as introduced February 23, 2007, would have resulted in a decrease of just under 12% in the amount of LLC fees collected versus the revenue estimate discussed in this analysis that results in a decrease of just over 12% in the amount of LLC fees collected. In addition, an LLC's fee is determined using a tiered chart, which means that although the method utilized to determine an LLC's total income assigned to California changed and resulted in a different amount of total income assigned to California, when applying the tiered chart, the LLC fee may remain the same.

The existing structure of LLC fees is being challenged in court. The estimate above is based on the assumption that the fees will ultimately be upheld. Should the courts reject the fees entirely and no legislative alternative is enacted, the potential revenue loss is estimated to be about \$1.3 billion for open tax years plus an ongoing cost that reaches over \$400 million per year by 2009/10. AB 198 does not address the potential loss of \$1.3 billion. It does reduce the potential ongoing revenue loss from about \$400 million to about \$50 million (for the 2009/10 fiscal year).

LEGISLATIVE STAFF CONTACT

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APPENDIX A

To the Members of the California State Assembly:

I am returning Assembly Bill 1614 without my signature.

This bill would impact how fees are collected from businesses choosing to operate as limited liability companies. As litigation is currently pending regarding this matter, it is premature to take legislative action at this time. For this reason, I am returning the bill without my signature.

Sincerely,

Arnold Schwarzenegger